8

IRAs

Deductible contributions. Contributions to a regular IRA of up to $2,000 a year are deductible if you and your spouse do not have retirement plan coverage where you work. If you have coverage, you may claim a deduction if your adjusted gross income is below a specified phase-out range; *see* ¶8.4. If your deduction is limited or eliminated under the phase-out rule, you may make nondeductible contributions, which must be reported on Form 8606; *see* ¶8.6.

SEP. Under a special type of IRA, a simplified employee pension (SEP) set up by your employer, you may make larger tax-sheltered contributions than you may make to a regular IRA; *see* ¶8.16.

Tax on IRA distributions. IRA distributions will be reported to you and to the IRS on Form 1099-R. The distributions are fully taxable, except to the extent you have made nondeductible contributions. You must file Form 8606 to figure the tax-free portion of distributions allocable to nondeductible contributions; *see* ¶8.9.

IRA distributions received before age 59½ are generally subject to a penalty (*see* ¶8.12 for exceptions). Minimum distributions from an IRA must begin after you reach age 70½; *see* ¶8.14.

Starting and Contributing to an IRA

¶8.1 Starting an IRA

There are two ways in which you may set up an IRA: (1) by making annual contributions (*see* ¶8.4 for deduction rules) and (2) by rolling over a distribution received from a qualified employer plan or from another IRA. Both types of IRA accounts provide tax-free accumulation of earnings until withdrawals are made. The rollover option also allows you to avoid immediate tax when you receive a lump-sum payment upon retirement, changing jobs, or disability; *see* ¶7.8. Tax-free interest compounding can produce the following funds for retirement:

	With interest compounded daily		
$2,000 invested annually—	**6%**	**8% gives you—**	**10%**
5 years	**$11,670**	**$12,794**	**$13,633**
10 years	**27,398**	**31,879**	**36,109**
15 years	**48,642**	**60,349**	**73,164**
20 years	**77,318**	**102,820**	**134,252**
25 years	**116,030**	**166,176**	**234,962**
30 years	**168,275**	**260,688**	**400,993**

IRA restrictions. Weigh the benefits from tax deductions for IRA contributions (¶8.3) and from tax-free compounding against these restrictions: Generally, you may not freely withdraw IRA funds until the year you reach age 59½ or become disabled. If you take money out before that time, you are subject to a penalty; *see* ¶8.8. Pledging the account as collateral is treated as a taxable distribution from the account; *see* ¶8.8. In the year you reach age 70½, you may no longer make IRA contributions, and you must start to withdraw (¶8.14) from the account. All IRA withdrawals are fully taxable except for amounts allocable to nondeductible contributions; *see* ¶8.8 and ¶8.9. Special averaging for lump-sum distributions does not apply. Excess contributions (¶8.7) and distributions (¶8.13) are penalized.

If your IRA loses value because of poor investments, you may not deduct the loss. A loss is allowed only if you make nondeductible contributions which you have not recovered when the account is depleted; *see* ¶8.9.

You may set up an IRA as:

1. *An individual retirement account* with a bank, savings and loan association, federally insured credit union, or other qualified person as trustee or custodian. An individual retirement account is technically a trust or custodial account. Your contribution may be invested in vehicles such as certificates of deposit, mutual funds, and certain limited partnerships.

Self-Directed IRA

If you wish to take a more active role in managing your IRA investments, you may set up a "self-directed" IRA using an IRS model form. The model trust (Form 5305) and the model custodial account agreement (Form 5305-A) meet the requirements of an exempt individual retirement account and so do not require a ruling or determination letter approving the exemption of the account and the deductibility of contributions made to the account. If you use this method, you still have to find a bank or other institution or trustee to handle your account or investment. If you have a self-directed IRA, you may not invest in collectibles, such as art works, gems, stamps, antiques, rugs, metals, or guns. Coins are not allowed unless they are state-issued coins or U.S. minted gold and silver coins of one ounce or less. Assets used to acquire a collectible are treated as distributions and are taxed.

2. *An individual retirement annuity* by purchasing an annuity contract (including a joint and survivor contract for the benefit of you and your spouse) issued by an insurance company; no trustee or custodian is required. The contract, endorsed to meet the terms of an IRA, is all that is required. Contracts issued after November 6, 1978, must provide for flexible premiums up to $2,000 a year, so that if your compensation changes, your payment may also change. As borrowing or pledging of the contract is not allowed under an IRA, the contracts will not contain loan provisions. Endowment contracts issued after November 6, 1978, that provide life insurance protection may not be used as individual retirement annuities.

You may set up one type of IRA one year and choose another form the next year. You also may split your contribution between two or more investment vehicles. For example, you are eligible to contribute $2,000. You may choose to put $1,000 into an investment retirement annuity and $1,000 into an individual retirement account with your local bank.

You do not have to file any forms with your tax return when you set up or make contributions to a deductible IRA. Form 8606 must be attached to Form 1040 or Form 1040A if you make nondeductible IRA contributions; *see* ¶8.6. The bank or company where you set up your IRA will report your contribution to the IRS on Form 5498, and you should receive a copy.

Trustee's fees and brokerage commissions. Trustee's fees paid to set up or manage an IRA are not considered IRA contributions provided they are separately billed. They are investment expenses which may be deducted as a miscellaneous itemized deduction subject to the 2% adjusted gross income floor; *see* ¶19.1. However, broker's commissions that are paid when you make investments for your IRA are not separately deductible, according to the IRS. They are considered IRA contributions subject to the $2,000 contribution limit.

Contributions after the end of the taxable year. You have until April 15, 1997 (the regular filing due date for your 1996 return), to make deductible or nondeductible IRA contributions for 1996. You must make your contribution by April 15, 1997, even if you get an extension to file your return. If you are short of cash, you may borrow the funds to make the contribution without jeopardizing the deduction. If an IRA deduction entitles you to a refund, you can file your return early, claim the IRA deduction, and if you receive the refund in time, apply it towards an IRA contribution before the due date.

CAUTION

Broker's Restriction on IRA Transfers

Before you invest in an IRA, carefully review the terms of the agreement for restrictions. One investor, who put his IRA in a brokerage account, was not allowed by the trustee to transfer from one account to another. Furthermore, the trustee reserved some of the IRA funds to cover broker fees and other transfer costs. The investor asked the IRS if these restrictions violated the tax law. The IRS, in a private letter ruling, said there was no violation. An IRA is a contractual agreement between the IRA trustee and the participant. Although the tax laws do not place limitations on direct IRA-to-IRA transfers, the trustees of a particular account may restrict such transfers.

¶8.2 Contributions Must Be Based on Earnings

You may make IRA contributions for 1996 of up to $2,000, provided you have wage, salary, or net self-employment earnings and that you have not reached age 70½ by the end of the year. If your earned income is less than $2,000, the contribution limit is 100% of your pay or net earned income if self-employed. Contributions for 1996 may be made up to the filing deadline of April 15, 1997; this is the deadline even if you obtain a filing extension.

If you are married and both you and your spouse work, you may each contribute up to $2,000 of earnings to an IRA. If you file a 1996 joint return with your spouse and only one of you has compensation, the combined contribution for both of you is $2,250; *see* ¶8.3.

Contributions up to these limits are *fully deductible* on your 1996 return if *neither you nor your spouse* is an active participant in an employer or self-employed retirement plan. Deductions for active plan participants are phased out for single persons with adjusted gross income over $25,000, and married persons filing jointly with adjusted gross income over $40,000. The phase-out rules are discussed at ¶8.4. Whether you should make nondeductible IRA contributions is discussed at ¶8.6.

IRA contributions must be based on payments received for rendering personal services, such as salary, wages, commissions, tips, fees, bonuses, jury fees, or net earnings from self-employment (less Keogh plan contributions on behalf of the self-employed). Compensation does *not* include:

1. Investment income such as interest, dividends, or profits from sales of property;
2. Deferred compensation, pensions, or annuities; or
3. Income earned abroad for which the foreign earned income exclusion is claimed.

EXAMPLE

A trader, whose sole income was derived from stock dividends and gains in buying and selling stocks contributed to an IRA. The IRS disallowed the deduction on the grounds that his income was not earned income.

If you live in a community property state, the fact that one-half of your spouse's income is considered your income does not entitle you to make contributions to an IRA. The contributions must be based on pay earned through your services.

Only cash contributions are deductible; contributions paid by check are considered cash for this purpose.

Self-employed may make IRA contributions. IRA contributions may be based on net self-employment earnings (¶46.1), after taking into account deductible Keogh or SEP retirement plan contributions (¶41.5) and the deduction for one-half of self-employment tax liability (¶46.3). If you have a net loss for the year, you may not make an IRA contribution unless you also have wages.

If you have more than one self-employed activity, you must aggregate profits and losses from all of your self-employed businesses to determine if you have net income on which to base an IRA contribution. For example, if one self-employed business produces a net profit of $15,000 but another a net loss of $20,000, you may not make an IRA contribution based on the net profit of $15,000. This netting rule does not apply to salary or wage income. If you are an employee who also has an unprofitable business, you may make an IRA contribution based on your salary.

If you have a self-employed retirement plan from your business, you are considered an active participant in a retirement plan for purposes of the adjusted gross income phase-out rules discussed at ¶8.4.

Taxable alimony. A divorced spouse with little or no earnings in 1996 may treat taxable alimony as compensation, giving a basis for deductible IRA contributions. If you are divorced, you make an IRA contribution equal to 100% of taxable alimony up to $2,000. However, the deduction may be reduced or eliminated if you are an active participant in an employer plan and your adjusted gross income exceeds the $25,000 threshold for unmarried individuals; *see* ¶8.4. Taxable alimony is alimony paid under a decree of divorce or legal separation, or a written agreement incident to such a decree; *see* Chapter 37. It does not include alimony payments made under a written agreement that is not incident to such a decree.

No contributions allowed for those age 70½. Even if you still have earnings, you may not make contributions to your IRA for the year in which you reach age 70½, or any later year. For example, if you were born in the last six months of 1926 or the first six months of 1927, you will reach age 70½ in 1997 and may not make any IRA

contributions (deductible or nondeductible) for 1997 or later years.

If you have a nonworking spouse under age 70½, you may contribute up to $2,000 to his or her IRA, even though no contribution may be made to your own IRA because you have reached age 70½; *see* ¶8.3.

¶8.3 IRA Contributions for Married Couples

If both you and your spouse earned compensation in 1996 and are under age 70½ at the end of the year, each of you may make an IRA contribution for 1996 of up to $2,000 by April 15, 1997.

Working for spouse. If you work for your spouse, you may make an IRA contribution provided you actually perform services and receive an actual payment of wages. A wife who worked as a receptionist and assistant to her husband, a veterinarian, failed to meet the second test. Her husband did not pay her a salary. Instead, he deposited all income from his business into a joint bank account held with his wife. In addition, no federal income tax was withheld from her wages. In a ruling, the IRS held that the wife could not set up her own IRA, even though she performed services; she failed to receive actual payment. Depositing business income into a joint account is neither actual nor constructive payment of the wife's salary. Furthermore, any deduction claimed for the wife's wages was disallowed.

Deductions for spouses filing jointly. If a joint return is filed and either spouse is an active participant in an employer plan, contributions are fully deductible if *modified adjusted gross income* (MAGI) on the joint return is $40,000 or less. Limited deductions are allowed if joint MAGI is between $40,000 and $50,000 under the phase-out rules explained at ¶8.4. No deduction is allowed for either spouse if joint return MAGI is $50,000 or more.

EXAMPLE

In 1996, Ray earns a salary of $20,000, his wife Ann earns $15,000, and neither is covered by an employer retirement plan. On a 1996 joint return, each of them may claim an IRA deduction of up to $2,000, for a maximum of $4,000. If only one of them worked, the maximum deduction would be $2,000, unless a spousal account for the nonworking spouse is set up as discussed below.

Even if Ray or Ann is an active participant in an employer plan, they are still allowed the maximum $4,000 deduction provided their combined MAGI on a joint return is $40,000 or less. If joint return MAGI is over $40,000 but less than $50,000, each may claim a limited deduction; *see* Example 2 at ¶8.4.

Deductions for spousal IRA on 1996 joint return. If you worked in 1996 but your spouse did not, you may make a contribution on behalf of your nonworking spouse provided you file a 1996 joint return. You may have two separate IRAs, one for you and one for your spouse, or a single IRA which has a subaccount for you and another subaccount for your spouse. A joint account is not allowed. However, each spouse may have a right of survivorship in the subaccount of the other.

Generally, the maximum contribution on the joint return is $2,250 and may be allocated between spouses in any way as long as no spouse receives a contribution exceeding $2,000. However, where deductions are limited under the rules of ¶8.3, the amount of deductible contributions which may be made for either spouse may be reduced; *see* Example 3 in ¶8.4.

Generally, you may set up an account (or subaccount) for your spouse only if your spouse received no compensation for the year, including tax-exempt foreign earned income. However, there is this limited exception: You may contribute to a spousal IRA if your spouse had compensation of $250 or less; your spouse is treated as if he or she had no compensation. You may set up a spousal account regardless of the amount of your spouse's unearned income, such as interest, dividends, or Social Security benefits.

Where your spouse earns less than $250, it is advantageous to set up a spousal IRA and qualify for the $2,250 contribution limit. Otherwise, the combined limit for both of you would be less than $2,250; you could contribute $2,000 to your IRA and your spouse could contribute only up to his or her compensation.

A spouse may start withdrawing from his or her spousal account (or subaccount) without penalty on reaching age 59½ and must start withdrawing on reaching age 70½.

If you are divorced, you may not maintain a spousal account for your former spouse. If you contributed to an account on behalf of your nonworking spouse and then divorce later in the year, the contribution is an excess contribution. IRAs based on alimony are discussed at ¶8.2.

An amount distributed to one spouse may not be rolled over to an IRA account of the other spouse, except in the case of divorce or death; *see* ¶8.11.

If you already have an IRA for yourself and you want to make contributions on behalf of your nonworking spouse, you may do so by merely opening a new IRA for your spouse and continuing your present IRA for yourself. However, if you have an annuity or endowment contract, check with your insurance agent about any contract restrictions on reducing your premium payments. Before setting up a single IRA with subaccounts for you and your spouse, check IRS regulations covering their use.

LAW ALERT

Higher Spousal IRA Contributions in 1997

A new law effective in 1997 increases the maximum IRA deduction for a married couple filing jointly from $2,250 to $4,000, up to $2,000 each, as long as their combined compensation is at least that much.

Contributions for spouses under age 70½. If you are over age 70½ and still working, you may contribute to a spousal IRA if your spouse is nonworking and is under age 70½ at the end of the year. The entire contribution must be allocated to the nonworking spouse. No contribution may be made to your own account for the year in

which you reach age 70½, or any later year. The contribution for your nonworking spouse may not exceed $2,000.

Married persons filing separately. If you are married, live together at any time during the year, file separately, and either of you is an active participant in an employer plan, the other spouse is also considered an active participant. Both of you are subject to the $0 to $10,000 AGI deduction phaseout; *see* Example 4 in ¶8.4.

If you live apart for the whole year, you each figure IRA deductions as if single. Thus, the more favorable deduction phase-out range of $25,000 to $35,000 applies if you are covered by an employer retirement plan; *see* Example 1 in ¶8.4. If you are *not* covered, you may claim a full deduction on your separate return.

¶8.4 Deduction Restrictions for Active Participants in Employer Plan

IRA deductions are restricted only for individuals who are covered by an employer or self-employed retirement plan, or for married persons where either spouse is covered. If you are unmarried or file as a head of household, and you are *not* covered by an employer or self-employed retirement plan, IRA contributions up to $2,000 are fully deductible provided your earned income is $2,000 or more. If you are married and *neither* spouse is covered, IRA contributions are fully deductible up to the $4,000 or $2,250 limit; *see* ¶8.3.

Are you an active participant in an employer retirement plan? If you are an employee, your 1996 Form W-2 should indicate whether you are covered for the year; if you are, the "pension plan" box within Box 15 of Form W-2 should be checked. *Generally, you are considered to be covered if you are an active participant in the plan for any part of the plan year ending within your taxable year;* see *the Sara Wartes Example below.* Active participation in a self-employed Keogh plan or SEP (Chapter 41) is treated as employer plan coverage for purposes of the IRA deduction phase-out rules. Active participation is explained further at ¶8.5.

EXAMPLE

Sara Wartes, a college teacher, quit her job in 1988 and withdrew all of the contributions she had made to her employee pension plan. The Tax Court held that Sara could not claim an IRA deduction in that year. Sara was an active participant in the college plan during 1988 and under the phase-out rules based upon adjusted gross income, no IRA deduction was allowed. The court noted that the active participation test is not made at the end of the year. Participation in a company plan at any time during the year triggers the deduction phase-out rules. This is true even where a person has forfeitable benefits.

If you or your spouse is an active plan participant. If you, or your spouse, is an active plan participant, you still may be allowed a full or limited deduction, but this will depend on whether your 1996 *modified adjusted gross income* (MAGI) is within the phase-out range shown below for your filing status.

MAGI is generally equal to the total income shown on your return *minus* adjustments to income other than for IRA deductions. However, if you are claiming an exclusion for interest on U.S. EE Savings Bonds used for tuition under the rules of ¶33.3, you must *add back* that interest to adjusted gross income to get MAGI. If you worked abroad and are claiming the foreign earned income exclusion (¶36.1), or a foreign housing exclusion or deduction (¶36.3), these amounts also must be added back to adjusted gross income to get MAGI.

The deduction phase-out rules apply only if your MAGI exceeds $25,000 if you are single or head of household, or $40,000 if married filing jointly or a qualifying widow or widower. If married filing separately and you lived with your spouse at any time during the year, the phase-out applies to the first $10,000 of MAGI on each separate return.

PHASE-OUT RANGE FOR $2,000 DEDUCTION LIMIT IF YOU OR YOUR SPOUSE IS AN ACTIVE PLAN PARTICIPANT

If you are—	*Deduction phased out if MAGI is—*	*No deduction if MAGI is—*
Single or head of household	$25,001 – $34,999	$35,000 or more
Married filing jointly	40,001 – 49,999	50,000 or more
Married filing separately	0 – 9,999	10,000 or more
Qualifying widow or widower	40,001 – 49,999	50,000 or more

How to figure your 1996 deduction if within the phase-out range. If you or your spouse is an active participant and your MAGI is *within* the phase-out range shown above, you may figure your reduced deduction using the following three steps:

Step 1. From your MAGI, subtract the following amount: $25,000 if single or head of household;

$40,000 if married filing jointly or a qualifying widow or widower; or

Zero if married filing separately.

If the result is $10,000 or more, stop; you are not allowed any deduction.

Step 2. Subtract Step 1 from $10,000.

Step 3. Multiply Step 2 by 20% (0.20) if your contribution limit is $2,000. Multiply Step 2 by 22.5% (0.225) if your contribution limit is $2,250 because you contribute to a spousal IRA (¶8.3). The result is your deductible contribution. If the result is not a multiple of $10, the allowable deduction is increased to the next highest $10; *see* Example 3 below. If the result is less than $200, a $200 deduction is allowed.

EXAMPLES

(All Examples follow steps 1–3 above and assume coverage under a company retirement plan. MAGI is before IRA deductions, but includes tax-free foreign earned income (¶36.1) and U.S. savings bond interest that is tax free under ¶33.3.)

1. *Single or head of household.* Rob Pace is single and his MAGI is $26,000. His maximum deductible IRA contribution for 1996 is $1,800.

   Step 1. $1,000 ($26,000 – $25,000).
   Step 2. $9,000 ($10,000 – $1,000).
   Step 3. $1,800 ($9,000 × 0.20).

   If he contributed $2,000 to the IRA, $200 will be treated as a nondeductible contribution.

2. *Married filing jointly.* Ted and his wife, Lynn, have a joint modified adjusted gross income in 1996 of $43,000. They file a joint return. Each of them works but only Ted is an active participant in an employer plan. Lynn is also considered an active participant under the IRA rules for married couples filing jointly. The maximum 1996 IRA deduction for *each of them* is $1,400.

   Step 1. $3,000 ($43,000 – $40,000).
   Step 2. $7,000 ($10,000 – $3,000).
   Step 3. $1,400 ($7,000 × 0.20).

   Note: If one spouse had compensation of less than $1,400, that spouse's contribution could not exceed such compensation.

3. *Spousal IRA.* Same facts as Example 2, but only Lynn works and is an active participant in an employer plan. Lynn sets up a spousal IRA for Ted, her nonworking spouse. The maximum deductible contribution for both accounts is $1,580.

   Step 1. $3,000 ($43,000 – $40,000).
   Step 2. $7,000 ($10,000 – $3,000).
   Step 3. $1,575 ($7,000 × 0.225).

   Since $1,575 is not a multiple of $10, the allowable deduction is increased to the next highest $10, or $1,580. Lynn may divide the $1,580 contribution between her and Ted in any way she chooses, but according to the IRS, neither of them may deduct more than $1,400, the deductible limit per spouse for a couple with a $43,000 MAGI, as figured under Example 2.

4. *Married filing separately.* Joe is married to Carol. They each work but only Joe is an active participant in an employer retirement plan. For 1996, they file separate returns. Joe's modified adjusted gross income is $7,500; Carol's is $21,000. Joe's maximum deductible IRA contribution is $500.

   Step 1.$7,500 ($7,500 – $0).
   Step 2.$2,500 ($10,000 – $7,500).
   Step 3.$500 ($2,500 × 0.20).

   Since Carol and Joe lived together during 1996, Joe's status as an active participant in an employer plan is also attributed to Carol although she did not actually have plan coverage. Carol is not allowed any deduction for IRA contributions on her separate return.

   Step 1. $21,000 ($21,000 – $0).

   Since Carol's MAGI of $21,000 exceeds the phase-out threshold ($0) by more than $10,000, no deduction is allowed.

   If Joe and Carol had lived apart for all of 1996, they would each figure their IRA deductions as if they were single, as in Example 1.

$200 IRA deduction floor. A special rule gives a $200 deduction if your MAGI without IRA deductions falls within the last $1,000 of the phase-out range. Using the three-step formula as just discussed, your reduced deduction would be less than $200 when your MAGI is over $34,000 (unmarried), over $49,000 (married filing jointly), or over $9,000 (married filing separately). However, a $200 deduction may be claimed by a single person with a MAGI of over $34,000 but under $35,000; by a married person filing jointly with a MAGI of over $49,000 but under $50,000; and by a married person filing separately with a MAGI of over $9,000 but under $10,000.

EXAMPLE

Pam Ford's MAGI is $34,400 in 1996 and she is filing as a head of household.

Step 1. $9,400 ($34,400 – $25,000).
Step 2. $600 ($10,000 – $9,400).
Step 3. $120 ($600 × 0.20).

Although $120 is the deductible IRA limit under the above computation, Pam may deduct contributions of up to $200.

Nondeductible contributions. Any contributions exceeding the amount allowed under the above rules are treated as nondeductible IRA contributions. *See* ¶8.6 for further details.

Figuring your IRA deduction if you receive Social Security benefits. If you or your spouse (¶8.3) is an active participant in an employer plan and either of you receives Social Security benefits, you need to make an extra computation before you can figure whether an IRA deduction is allowed. Follow the rules of ¶34.3 to determine if part of your Social Security benefits would be subject to tax, assuming no IRA deduction were claimed. If none of your benefits would be taxable, you follow the regular rules above for determining IRA deductions. If part of your Social Security benefits would be taxable, MAGI for IRA purposes is increased by the taxable benefits. The allowable IRA deduction is then taken into account to determine the actual amount of taxable Social Security.

¶8.5 Active Participation in Employer Plan

Active participants in an employer retirement plan are subject to the adjusted gross income tests for deducting contributions as discussed at ¶8.4. Married individuals are generally treated as active participants if either spouse has plan coverage; *see* ¶8.3. An employer retirement plan means:

1. A qualified pension, profit-sharing, or stock bonus plan, including a qualified self-employed Keogh plan or simplified employee pension (SEP) plan;

2. A qualified annuity plan;
3. A tax-sheltered annuity; and
4. A plan established for its employees by the United States, by a state or political subdivision, or by any agency or instrumentality of the United States or a state or political subdivision, but *not* eligible state Section 457 plans.

Form W-2. If your employer checks the "Pension plan" box within Box 15 of your 1996 Form W-2, this indicates that you were an active participant in your employer's retirement plan during the year. If you want to make a contribution before you receive your Form W-2, check the following guidelines and consult your plan administrator for your status.

Type of plan. Under any type of plan, if you are considered an active participant for *any part* of the plan year ending with or within your taxable year, you are treated as an active participant for the entire taxable year. Because of this plan year rule, you may be treated as an active participant even if you worked for the employer only part of the year. Under IRS guidelines, it is possible to be treated as an active participant in the year of retirement and even in the year after retirement if your employer maintains a fiscal year plan.

The plan year rule works differently for defined benefit pension plans than for defined contribution plans such as profit-sharing plans, 401(k) plans, money purchase pension plans, and stock bonus plans. These rules are discussed below.

If you are married, and either of you is treated as an active participant, so is the other. The only exception is if you file separately and live apart for the whole year; *see* ¶8.4.

Defined benefit pension plans. You are treated as an active participant in a defined benefit pension plan if, for the plan year ending with or within your taxable year, you are eligible to participate in the plan. Under this rule, as long as you are eligible, you are treated as an active participant, even if you decline participation in the plan or you fail to make a mandatory contribution specified in the plan. Furthermore, you are treated as an active participant even if your rights to benefits are not vested.

Defined contribution plan. For a defined contribution plan, you are generally considered an active participant if "with respect to" the plan year ending with or within your taxable year (1) you make elective deferrals to the plan; (2) your employer contributes to your account; or (3) forfeitures are allocated to your account. If any of these events occur, you are treated as an active participant for that taxable year, even if you do not have a vested right to receive benefits from your account.

EXAMPLES

1. Pat O'Neil joins a company that has a 401(k) plan (a type of defined contribution plan) with a plan year starting July 1 and ending the following June 30. He is not eligible to participate in the plan year ending June 30, 1996. He elects to defer 6% of his 1996 salary to the 401(k) plan for the plan year ending June 30, 1997. Although he makes elective deferrals to the plan during 1996, he is *not* considered an active participant for 1996 because his contributions were made for the plan year ending in 1997. He *will* be considered an active participant in 1997, even if he decides not to defer any part of his 1997 salary for the plan year ending June 30, 1998.
2. Clarise Jones's employer has a defined benefit pension plan with a plan year starting July 1 and ending the following June 30. She is not excluded from participating. If she retired during September 1995, she is considered an active participant for 1995 because she was eligible to participate during the plan year ending during 1995. She will also be considered an active participant for 1996. Although she will retire before the end of the plan year starting July 1, 1995, and ending June 30, 1996, she will still be eligible to participate during part of that plan year (July 1, 1995, until retirement in September 1995), and since the 1995–1996 plan year ends within her 1996 tax year, she will be considered an active participant for 1996.

¶8.6 Nondeductible IRA Contributions

If you are not allowed to deduct any IRA contributions for 1996 because of the phase-out rule (¶8.4), you may make *nondeductible* contributions of up to $2,000, or $2,250 for a spousal IRA (¶8.3), where you have compensation of at least that much. If a deduction of less than $2,000 ($2,250 for spousal IRA) is allowed under the phase-out rules, you may make a nondeductible contribution to the extent the maximum contribution limit of $2,000, $2,250, or $4,000 exceeds the deductible limit figured under ¶8.4. Thus, if you are limited to a $1,800 deduction because your adjusted gross income is within the deduction phase-out range (¶8.4), you may make a $200 nondeductible contribution. As with deductible contributions, nondeductible contributions for 1996 may be made up to the April 15, 1997 filing due date (without extensions). The advantage of making nondeductible contributions is that earnings on the account accumulate tax free until withdrawn.

Form 8606. You must file Form 8606 to report nondeductible IRA contributions unless you withdraw the contribution as discussed below. You also must list on Form 8606 the value of all of your IRAs as of the end of the year, including amounts based on deductible contributions. If you are married and you and your spouse both make nondeductible contributions, you must each file a separate Form 8606. A $50 penalty may be imposed for not filing Form 8606 unless there is reasonable cause. Furthermore, if you overstate the amount of designated nondeductible contributions made for any taxable year, you are subject to a $100 penalty for each such overstatement unless you can demonstrate that the overstatement was due to reasonable cause. You may file an amended return for a taxable year and change the designation of IRA contributions from deductible to nondeductible or nondeductible to deductible.

If you make contributions during the year, you may not know whether you will be allowed to claim a deduction under the phase-out rules of ¶8.4. For example, you may have employer plan cover-

age but might not know whether your MAGI will exceed the $35,000 limit (single) or $50,000 limit (married filing jointly). You can make your contribution without knowing whether it is deductible or not and figure your deduction when you file your return. Any nondeductible amount would be reported on Form 8606. However, if you do not want to make nondeductible contributions, you may wait until after the end of the year when you can determine your MAGI and active participant status; you have until the April filing due date (without extensions) to make your contribution; for 1996 returns, the filing due date is April 15, 1997.

Form 8606 for IRA Distributions

Keep a copy of each Form 8606 filed showing nondeductible contributions and keep a separate record of deductible contributions. When you make IRA withdrawals, the portion of each withdrawal allocable to nondeductible contributions is not taxed. You may not completely avoid tax even if you withdraw an amount equal to your nondeductible contributions. The tax-free portion of the withdrawal is figured on Form 8606. The rules for figuring tax on withdrawals and a sample Form 8606 are at ¶8.9.

Withdrawing nondeductible contributions. If you make an IRA contribution for 1996 and later realize it is not deductible, you may make a tax-free withdrawal of the contribution by the filing due date (*plus* extensions), instead of designating the contribution as nondeductible on Form 8606. To do this, you must also withdraw the earnings allocable to the withdrawn contribution and include the earnings as income on your 1996 return. You might want to make the withdrawal if you incorrectly determined that a contribution would be deductible and you do not want to leave nondeductible contributions in your account. However, making the withdrawal could subject you to bank penalties for premature withdrawals, or other withdrawal penalties imposed by the IRA trustee. Furthermore, if you are under age 59½ and not disabled, the 10% premature withdrawal penalty (¶8.8) applies to the withdrawn earnings.

Should you make nondeductible IRA contributions? Yes, if in your case the accumulation of tax-free income in the account, when you withdraw the account, will give you a greater return than other types of investments. Generally a nondeductible account should be considered when you intend to leave it intact until you retire. However, if you have other IRA accounts based on deductible contributions, withdrawals from a nondeductible account may be taxable as explained in ¶8.8. This is a disadvantage as you may not treat the account as a regular savings account from which you can make tax-free withdrawals at any time.

Note: *Proposals have been made in Congress to create a new type of nondeductible IRA from which tax-free distributions could be made after a five-year holding period if the funds were used to buy a qualifying first home, or to pay higher education or medical expenses. Individuals age 59½ and older could receive tax-free distributions after the five-year holding period regardless of the way they use the funds. Developments, if any, will be reported in the Supplement.*

¶8.7 Penalty for Excess IRA Contributions

If you contribute more than the allowable amount, whether deductible or nondeductible, the excess contribution may be subject to a penalty tax of 6%. The penalty tax is cumulative. That is, unless you correct the excess, you will be subject to another penalty on the excess contribution in the following year. The penalty tax is not deductible. The penalty is figured in Part II of Form 5329, which must be attached to Form 1040.

The 6% penalty may be avoided by withdrawing the excess contribution by the due date for your return, including extensions, plus any income earned on it. The withdrawn excess is not taxable provided no deduction was allowed for it. The withdrawn income must be reported as income on your return for the year in which the excess contribution was made. If you are under age 59½ (and not disabled) when you receive the income, the 10% premature withdrawal penalty applies to the income. Similar rules apply to withdrawals of excess employer contributions to a simplified employee pension plan (¶8.16) made by the due date for your return.

If an excess contribution for 1996 is not withdrawn by the due date for your 1996 return, the 6% penalty will apply to your 1996 return but it may be avoided for 1997 by withdrawing the excess by the end of 1997. You may also avoid a penalty for 1997 by reducing your allowable 1997 IRA contribution by the 1996 excess and then including that amount in your 1997 IRA deduction. *See* IRS Publication 590 and Form 5329 for details.

If you deducted an excess contribution in an earlier year for which total contributions were $2,250 or less, you may make a tax-free withdrawal of the excess by filing an amended return to correct the excess deduction. However, the 6% penalty tax applies for each year that the excess was still in the account at the end of the year.

After the due date of your return, you may make a tax-free withdrawal of excess employer contributions to a simplified employee pension plan (¶8.16) if they are $30,000 or less. However, the 6% penalty tax applies for each year that the excess was still in the account at the end of the year.

See IRS Publication 590 for further information on correcting excess contributions made in a prior year.

Taking Money Out of an IRA

¶8.8 Taxable IRA Distributions

If all of your IRA contributions were deductible, any IRA distribution you receive that you do not roll over or redeposit within 60 days (¶8.10) will be taxable. Not only are distributions taxable, but the timing and amount of IRA payments is subject to these restrictions:

- Distributions before age 59½ are subject to a 10% tax penalty, unless you are totally disabled or you receive annual payments under an annuity-type schedule. The penalty and the exceptions are discussed at ¶8.12.
- After you reach age 70½, you must start to receive annual distributions under a life-expectancy calculation. The required starting date is the April 1 of the year after the year in which you reach age 70½. For example, if you reach age 70½ during 1996, you must start taking IRA distributions by April 1, 1997. Failure to take the minimum required annual distribution can result in penalties. These rules are discussed in ¶8.14.
- Distributions in 1996 of over $155,000 are subject to a 15% penalty, regardless of your age, as discussed at ¶8.13.

How to report IRA distributions on your return. All IRA distributions are reported to you and to the IRS on Form 1099-R; *see* the guide to Form 1099-R on page 123. Form 1099-R must be attached to your return only if federal tax has been withheld. You can avoid withholding by instructing the payer not to withhold on Form W-4P (or a substitute form); *see* ¶26.11.

If you have never made nondeductible contributions, your IRA withdrawals are fully taxable and should be reported on Line 15b of Form 1040 or Line 10b of Form 1040A. If you have made deductible and nondeductible contributions, complete Form 8606 to figure the nontaxable and taxable portions as discussed in ¶8.9. Then you report the total IRA withdrawal on Line 15a of Form 1040 or Line 10a of Form 1040A and enter only the taxable portion on Line 15b or Line 10b, respectively.

If you have an individual retirement annuity, your investment in the contract is treated as zero so all payments are fully taxable. Distributions from an endowment policy due to death are taxed as ordinary income to the extent allocable to retirement savings; to the extent allocable to life insurance, they are considered insurance proceeds.

Proceeds from U.S. retirement bonds (which were issued by the Treasury before May 1982) are taxable in the year the bonds are redeemed. However, you must report the full proceeds in the year you reach age 70½ even if you do not redeem the bonds.

Loan treated as distribution. If you borrow from your IRA account or use it as security for a loan, you generally are considered to have received your entire interest. Borrowing will subject the account or the fair market value of the contract to tax at ordinary income rates as of the first day of the taxable year of the borrowing. Your IRA account loses its tax-exempt status. If you use the account or part of it as security for a loan, the portion that is pledged is treated as a distribution.

However, under the rollover rules, a short-term loan may be made by withdrawing IRA funds and redepositing them in an IRA within 60 days, subject to the once-a-year rollover rule at ¶8.10.

IRS seizure of IRA treated as distribution. The Tax Court has held that an IRS levy of an IRA to cover back taxes is a taxable distribution to the account owner, even though the funds are transferred directly from the account to the IRS and not actually received by the owner. Where the owner is under age 59½, the Tax Court has held that the 10% penalty for early withdrawals does not apply to involuntary distributions attributable to an IRS levy.

¶8.9 Partially Tax-Free Distributions Allocable to Nondeductible Contributions

If you ever made a nondeductible IRA contribution, you must file Form 8606 when you receive a distribution from any of your IRAs, even if the distribution is from an IRA to which only deductible contributions were made. All of your IRAs are treated as one contract. If you receive distributions from more than one IRA in the same year, they are combined for reporting purposes on Form 8606.

When you withdraw an amount from any IRA during a taxable year and you previously made both deductible and nondeductible IRA contributions, the part of your withdrawal that is allocable to your nondeductible contributions is tax free; any balance is taxable. You make the computations on Form 8606. The six steps on the next page reflect the IRS method used on Form 8606 to figure the nontaxable and taxable portions of the IRA distributions.

These withdrawal allocation rules penalize you if you make nondeductible contributions and later decide to make withdrawals from the "nondeductible account." You may not claim that you are withdrawing only your tax-free contributions, even if your withdrawal is less than your nondeductible contributions. If you withdraw amounts from your nondeductible account, you will incur tax.

The payer of an IRA account, such as a bank, will report withdrawals from an IRA account to the IRS on Form 1099-R as if they are taxable. It is up to you to keep records that show the nondeductible contributions you have made. IRS instructions require you to keep copies of all Forms 8606 on which nondeductible contributions have been designated, as well as copies of (1) your tax returns for years you made nondeductible contributions; (2) Forms 5498 showing all IRA contributions and showing the value of your IRAs for each year you received a distribution; and (3) Form 1099-R and Form W-2P showing IRA distributions. According to the IRS, you should keep such records until you have withdrawn all IRA funds.

Follow these steps in determining the tax-free and taxable portion of IRA distributions received during 1996:

Step 1. Total IRA withdrawals during 1996.

Step 2. Total nondeductible contributions to all IRAs made by the end of 1996. Tax-free withdrawals of nondeductible contributions in prior years reduce the total. If you made an IRA contribution for 1996 (including a contribution made between January 1 and April 15, 1997) that may be *partly* nondeductible because your modified adjusted gross income is within the deduction phase-out range shown in ¶8.4 for active plan participants, you should include that entire contribution in the Step 2 total.

Step 3. Add Step 1 to the balance of all your IRAs at the end of 1996. If you received an IRA distribution within the last 60 days of 1996 which was rolled over to another IRA within the 60-day rollover period (¶8.10) *but* not until 1997, add the 1997 rollover to the year-end balance.

Step 4. Divide Step 2 by Step 3. This is the tax-free percentage of your IRA withdrawal.

Step 5. Multiply the Step 4 percentage by Step 1. This amount is tax free.

Step 6. Subtract Step 5 from Step 1. This amount is fully taxable.

EXAMPLE

In 1996, Nick James withdraws $5,000 from his IRA, having made deductible IRA contributions of $8,000 and nondeductible contributions of $6,000 as follows:

Year	*Deductible*	*Nondeductible*
1989	$2,000	– 0 –
1990	2,000	– 0 –
1991	2,000	– 0 –
1992	1,000	$1,000
1993	1,000	1,000
1994	– 0 –	2,000
1995	– 0 –	2,000
	$8,000	$6,000

Assume that at the end of 1996, Nick's total IRA account balance, including earnings, is $17,500, and that this is his first IRA withdrawal. On his 1996 return, $1,350 of the $5,000 IRA withdrawal will be tax free and $3,650 will be taxable.

Step 1.	IRA withdrawal	$5,000
Step 2.	Nondeductible contributions	6,000
Step 3.	IRA balance at end of the year ($17,500) *plus* Step 1	22,500
Step 4.	Tax-free percentage: $6,000 ÷ $22,500	27%
Step 5.	Tax-free withdrawal: 27% × $5,000	1,350
Step 6.	Taxable withdrawal: $5,000 – $1,350	$3,650

The total $5,000 withdrawal should be reported on Line 15a of Form 1040 or on Line 10a of Form 1040A, and the taxable $3,650 portion should be entered on Line 15b (Form 1040) or on Line 10b (Form 1040A).

On the sample Form 8606 worksheet, the $6,000 of nondeductible contributions are shown on Line 2 and the $5,000 withdrawal on Line 7. The tax-free percentage of 27% is shown on Line 9 and the $1,350 tax-free withdrawal on Line 10. The remaining IRA basis of $4,650 ($6,000 – $1,350) is shown on Line 12.

Deductible IRA loss based on unrecovered nondeductible contributions. According to the IRS, a loss may be allowed if all IRA funds have been distributed and you have not recovered your basis in nondeductible contributions.

EXAMPLE

Paula Brown makes nondeductible IRA contributions of $10,000 from 1991–1995. At the end of 1996, she withdraws $6,000. The year-end balance is $8,000. The tax-free portion of the withdrawal is $4,286 ($10,000 nondeductible contributions ÷ $14,000 total of withdrawal plus year-end balance × $6,000 withdrawal).

After the withdrawal, her account balance is $8,000; her basis is $5,714 ($10,000 – $4,286). If because of poor investments the value of the IRA fell to $3,000 by the end of 1997 and she withdrew the entire $3,000 balance, she could claim a $2,714 loss ($5,714 basis – $3,000 distribution).

Form 8606—Worksheet

1	Enter your IRA contributions for 1996 that you choose to be nondeductible. Include those made during 1/1/97–4/15/97 that were for 1996. See instructions	1	0
2	Enter your total IRA basis for 1995 and earlier years. See instructions	2	6,000
3	Add lines 1 and 2	3	6,000
	Did you receive any IRA distributions (withdrawals) in 1996? — No → Enter the amount from line 3 on line 13. Then, **stop** and read **When and Where To File** on page 2. — Yes → Go to line 4		
4	Enter only those contributions included on line 1 that were made during 1/1/97–4/15/97. This amount will be the same as line 1 if all of your nondeductible contributions for 1996 were made in 1997 by 4/15/97. See instructions	4	0
5	Subtract line 4 from line 3	5	6,000
6	Enter the total value of **ALL** your IRAs as of 12/31/96 plus any outstanding rollovers. See instructions	6	17,500
7	Enter the total IRA distributions received during 1996. Do not include amounts rolled over before 1/1/97. See instructions	7	5,000
8	Add lines 6 and 7	8	22,500
9	Divide line 7 by line 8 and enter the result as a decimal (to at least two places). Do not enter more than "1.00"	9	× .27
10	Multiply line 7 by line 9. This is the amount of your **nontaxable distributions** for **1996**	10	1,350
11	Subtract line 10 from line **5**. This is the **basis in your IRA(s) as** of **12/31/96**	11	4,650
12	Add lines 4 and 11. This is your **total IRA basis for 1996 and earlier years**	12	4,650
	Taxable Distributions for 1996		
13	Subtract line 10 from line 7. Enter the result here and on Form 1040, line 15b, Form 1040A, line 10b, Form 1040NR, line 16b, whichever applies	13	3,650

¶8.10 Tax-Free Rollovers and Direct Transfers to IRAs

There are two types of tax-free rollovers that you can make to an IRA. You may roll over funds to an IRA from a qualified company or self-employed retirement plan, as discussed at ¶7.8. You may also use a rollover to switch funds from one IRA to another, although another option, a direct transfer, may be a more advantageous way of changing IRA investments.

Direct transfer. A *direct transfer* is made by instructing the trustee of an IRA to transfer all or part of your account to another IRA trustee. Direct transfers are tax free because you do not receive the funds. The tax law does not require a waiting period between direct transfers, whereas rollovers are subject to a once-a-year limitation, as discussed below.

For example, assume you have an IRA at Bank "A" and decide to switch your account to Mutual Fund "ABC." The mutual fund will provide you with transfer request forms which you complete and return to the fund, which will then forward the forms to the bank to complete the direct transfer. The transfer from the bank to the mutual fund is tax free. Because the IRA funds were not paid to you, the transfer is not considered a rollover subject to the once-a-year rollover limitation. This means that if within one year you become unhappy with the performance of Mutual Fund "ABC," you may make another tax-free direct transfer of your IRA to Fund "XYZ" or to Bank "B."

Rollover. With a *rollover* you withdraw funds from an IRA and have 60 days to invest in another IRA. To avoid tax on a *rollover* from one IRA to another, these tests must be met: (1) The amount you receive from your old IRA must be transferred to the new plan within 60 days of your receiving it; and (2) a tax-free rollover may occur only once in a one-year period starting on the date you receive the first distribution. If within that one-year period you receive a distribution from the previously rolled over IRA, the distribution is taxable and if you are under age 59½, could be subject to the 10% penalty for premature distributions; *see* ¶8.12. A *direct transfer* may be used as discussed above if you want to invest in another IRA within the one-year period.

The once-a-year rollover rule applies separately to each of your IRAs. For example, you have one IRA invested in a bank and another IRA invested in a mutual fund. Within the same one-year period, you may roll over the bank IRA to a different IRA and you may also roll over the mutual-fund IRA to a different IRA. However, neither of the new IRAs may be rolled over again within the one-year period starting on the date that you received the distribution from the original IRA plan.

There is an exception to the one-year waiting period between rollovers if the second distribution is made from an insolvent financial institution by the FDIC (Federal Deposit Insurance Corporation) or the RTC (Resolution Trust Company) acting as receiver. The exception applies only if the receiver makes the distribution to you because it is unable to find a buyer for the insolvent institution.

60-Day Loan from IRA

You can take advantage of the rollover rule to borrow funds from your IRA if you need a short-term loan to pay your taxes or other expenses. As long as you redeposit the amount in an IRA within 60 days you are not taxed on the withdrawal; the redeposit is considered a tax-free rollover. You may roll over the funds to a different IRA from the one from which the withdrawal was made. A second withdrawal from the same IRA within one year would be taxable as previously discussed.

Deposits in insolvent financial institutions. The 60-day limit for completing a rollover is extended if the funds are "frozen" and may not be withdrawn from a bankrupt or insolvent financial institution. The 60-day period is extended while the account is frozen and you have a minimum of 10 days after the release of the funds to complete the rollover.

If a government agency takes control of an insolvent bank, you might receive an "involuntary" distribution of your IRA account from the agency. According to the IRS and Tax Court, such a payment is subject to the regular IRA distribution rules. For example, a couple received payment for their $11,000 IRA balance from the Maryland Deposit Insurance Fund after the bank in which the funds were invested became insolvent. The Tax Court held that the payment was taxable, even though the distribution was from a state insurance fund and not from the bank itself. Furthermore, since they were under age 59½, the 10% penalty for early distributions (¶8.12) was imposed, even though the distribution was involuntary. The tax and penalty could have been avoided by making a rollover of the distribution within 60 days, but this was not done.

Reporting a Rollover on Your 1996 Return

If you rolled over a qualifying distribution from an employer plan to an IRA (¶7.8), report the total distribution on Line 16a of Form 1040 or Line 11a of Form 1040A. Enter zero as the taxable amount on Line 16b or Line 11b if the entire amount was rolled over. If only part of the distribution was rolled over, enter the portion *not* rolled over on Line 16b or Line 11b.

If you rolled over funds from one IRA to another, the total distribution should be reported on Line 15a of Form 1040 or Line 10a of Form 1040A. If the entire distribution was rolled over, enter zero as the taxable amount on Line 15b or Line 10b. Otherwise, enter the amount *not* rolled over on Line 15b or Line 10b.

If you made a tax-free direct transfer from one IRA to another, you do not have to report it on your return.

¶8.11 Transfer of IRA to Spouse at Divorce or Death

If you receive your former spouse's IRA pursuant to a divorce decree or written instrument incident to the decree, the transfer is not taxable to either of you. From the date of transfer the account is treated as your IRA. If you are legally separated, a transfer of your spouse's IRA to you is tax free if made under a decree of separate maintenance or written instrument incident to the decree. The transferred account is then treated as your IRA.

QDRO transfer to IRA. If you receive your share of your spouse's or former spouse's benefits from an employer plan under a qualified domestic relations order (QDRO), the distribution is taxable to you unless you roll it over to an IRA. Special averaging may be available; *see* ¶7.12. If you roll over only part of a qualifying QDRO distribution, you figure the tax on the retained portion by taking into account a pro-rated share of your former spouse's cost investment.

Surviving spouse. If you inherit your spouse's IRA when he or she dies, you may elect to treat the IRA as your own, or you may receive distributions from the account as a beneficiary. *See* ¶8.15 for a discussion of these options.

¶8.12 Penalty for IRA Withdrawals Before Age 59½

The 10% penalty applies to any IRA distribution you receive before age 59½, unless you make a qualifying rollover to another IRA (¶8.10), you are totally disabled, or the distribution is one of a series of payments being made under the annuity-type schedule methods discussed on the next page. Beneficiaries receiving IRA funds following the death of the owner are exempt from the penalty.

The penalty is 10% of the taxable IRA distribution. For example, if before age 59½, you withdraw $3,000 from your IRA, you must include the $3,000 as part of your taxable income and, in addition, pay a $300 penalty tax. If part of a premature distribution is tax free because it is allocable to nondeductible contributions (see ¶8.9) or rolled over to another IRA (¶8.10), the 10% penalty applies only to the taxable portion of the distribution.

If you are subject to the 10% early distribution penalty but not to the penalties discussed at ¶8.7, ¶8.13, or ¶8.14, the penalty is entered directly on Form 1040, Line 48.

If you do not owe the penalty because you qualify for an exception, you may have to file Form 5329, depending on whether the payer of the distribution correctly marked the exception in Box 7 of Form 1099-R. If you qualify for the annuity-method exception and

the payer correctly indicated that exception by marking Code 2 in Box 7, you do not have to file Form 5329. Similarly, if you are the beneficiary of a deceased IRA owner and the payer has correctly noted that with Code 4 in Box 7, you do not have to file Form 5329 to claim the exception.

If you qualify for the disability exception (see below), it is unlikely that the payer will know of that fact and thus Code 3 (for the disability exception) will probably not be marked in Box 7 of Form 1099-R. In that case, you must file Form 5329 to claim the exception. You also must file Form 5329 if the annuity method or beneficiary exception applies but it is not coded in Box 7 of Form 1099-R.

If you rolled over your entire distribution within 60 days to another IRA (¶8.10), the penalty does not apply and Form 5329 does not have to be filed.

Spousal beneficiaries. If you inherit an IRA from your deceased spouse and elect to treat it as your *own* IRA as discussed at ¶8.15, you are not eligible for the beneficiary exception; distributions from the account before you reach age 59½ will be subject to the penalty. The exception applies if the account is maintained in the name of your deceased spouse and you are receiving the distribution as a spousal beneficiary under the rules at ¶8.15.

Disability exception. To qualify for the disability exception, you must be able to show that you have a physical or mental condition that can be expected to last indefinitely or result in death and that prevents you from engaging in "substantial gainful activity" similar to the type of work you were doing before the condition arose.

In one case, a 53-year old stockbroker claimed that his IRA withdrawal of over $200,000 should be exempt from the 10% penalty because he suffered from mental depression. However, the Tax Court upheld the IRS imposition of the penalty because he continued to work as a stockbroker.

LAW ALERT

Medical Expense Exceptions to Penalty

Starting in 1997, the 10% penalty does not apply to IRA withdrawals used to pay medical expenses during the year in excess of 7.5% of adjusted gross income.

In addition, after 1996 unemployed individuals who have received unemployment benefits under Federal or state law for at least 12 weeks may make penalty-free IRA withdrawals to the extent of medical insurance premiums paid during the year. The withdrawals may be made in the year the 12-week unemployment test is met, or in the following year. However, the penalty exception does not apply to distributions made more than 60 days after the individual returns to the work force.

Self-employed persons who are ineligible by law for unemployment benefits may be treated as meeting the 12-week test, and thus eligible for the exception, under regulations to be issued by the IRS.

ANNUITY-SCHEDULE PAYMENTS AVOID 10% PENALTY

You may avoid the penalty if you are willing to receive annual distributions under one of the annuity-type methods discussed in this section. Before arranging an annuity-type schedule, consider these points: all of the payments will be taxable (unless allocable to nondeductible contributions under ¶8.8), and if you do not continue the payments for a minimum number of years, the IRS will impose the 10% penalty for all taxable payments received before age 59½, plus interest charges.

The payments must continue for five years, or until you reach age 59½, whichever period is *longer.* Thus, if you are in your 40s, you would have to continue the scheduled payments until you are age 59½. If you are in your mid-50s, the minimum payout period is not as serious a burden, as you only need to continue the scheduled payments for a five-year period, starting with the date of the first distribution, provided that the period ends after you reach age 59½. During this minimum period, the arranged annuity-type schedule may not be changed. For example, taking a lump-sum distribution of your account balance before reaching age 59½ would trigger the retroactive penalty, plus interest charges. After the minimum payout period, you can discontinue the payments or change the method without penalty.

The minimum payout period rules do not apply to totally disabled individuals or to beneficiaries of deceased IRA owners.

If you would like to take advantage of this penalty exception, you may apply one of the following three payout methods that have been approved by the IRS in private rulings:

1. Life expectancy method. This is the easiest method to figure but provides smaller annual payments than the other methods. Figure the annual withdrawal by dividing your account balance by your life expectancy or by the joint life and last survivor expectancy of you and your beneficiary. This is the same method discussed at ¶8.13 for figuring minimum required distributions after age 70½.

For example, you are age 50 in 1997 and have an IRA of $100,000 at the beginning of the year. You may take a penalty-free payment of $3,021 in 1997 ($100,000 account balance ÷ 33.1 life expectancy). Individual life expectancies are shown in Table V at ¶7.23. The annual penalty-free amount will generally increase in later years, with the exact amount depending on your account balance and whether you recalculate your life expectancy under the table each year (based on your age) or you simply reduce your life expectancy by one for each year that has elapsed since the year that you received the first payment.

If instead of using your single life expectancy you used the joint life and last survivor expectancy of you and your beneficiary (*see* sample table on page 172) the annual penalty-free amount would be smaller given the longer joint life expectancy. For example, if your beneficiary was age 45, your joint life and last survivor life expectancy would be 42 years (using ages 50 and 45), and the penalty-free withdrawal $2,381 ($100,000 account balance ÷ 42). *See* page 172 for the sample section of the IRS joint life and last survivor life expectancy table. The full IRS Table VI showing joint life and last survivor life expectancy is in IRS Publication 939 and can also be obtained from your IRA trustee.

2. Amortization method. Under this method, you amortize your IRA account balance like a mortgage, using the same life expectancy as under Method 1 (your single life expectancy or the joint life and last survivor expectancy of you and your beneficiary) and a long-term interest rate that is reasonable when the payments commence. In private rulings, the IRS approved the use of interest rates based on federal rates, such as the applicable federal rate used for figuring minimum interest on seller-financed sales (¶4.32), or the rate of interest under Pension Benefit Guaranty Corporation regulations.

Under the amortization method, the annual penalty-free withdrawal will be larger than under Method 1. For example, using an interest rate of 8% (assuming that is a reasonable rate), a 50-year-old with a $100,000 account balance may withdraw $8,679 without penalty in the first year, as opposed to $3,021 under Method 1. The payment in future years will depend on how life expectancy is adjusted.

3. Annuity factor method. This method is similar to the amortization method but it allows you to use insurance mortality tables (such as the UP-1984 Mortality Table) that project shorter life expectancy tables than the IRS life expectancy tables used under Methods 1 and 2. If an interest rate of 8% and the UP-1984 mortality table were used for a 50-year-old with a $100,000 account balance, the penalty-free withdrawal in the first year would be $9,002, as opposed to $3,021 under Method 1 or $8,679 under Method 2.

Note: For Methods 2 and 3, you should get the assistance of a tax professional and an actuary to help plan a series of payments that will qualify for the penalty exception.

¶8.13 Penalty for Excess IRA Distributions

IRA distributions exceeding $155,000 in 1996 may be subject to a 15% penalty. The penalty is imposed on the excess over $155,000 unless an exception to the penalty is available. For example, the penalty on a $200,000 IRA distribution in 1996 would be $6,750 (15% × $45,000, excess over $155,000). If you receive an IRA distribution and make a tax-free rollover to another IRA within 60 days, the penalty does not apply. The penalty does not apply to distributions attributable to nondeductible contributions. Beneficiaries do not have to pay the penalty on distributions from the deceased IRA owner's account.

If on your 1987 or 1988 return you made the "grandfather" election discussed at ¶7.15, the penalty threshold for 1996 is the greater of $155,000 and the amount treated as the 1996 recovery of the "grandfathered" amount; *see* the Form 5329 instructions.

¶8.14 Mandatory Distributions After Age 70½

By April 1 of the year following the year in which you reach age 70½, you have to start receiving annual IRA distributions under a schedule that meets tax law tests. If you receive an insufficient annual distribution, a penalty tax of 50% applies to the difference between the amount you should have received and the amount you did receive. The penalty is reported on Form 5329, which must be attached to Form 1040.

EXAMPLE

During 1996, Chris Calano reaches age 70½ and receives $500 from his IRA plan. The minimum amount required to be paid to him was $700. He must pay a penalty tax of $100 (50% of $200), unless it is waived by the IRS.

When must your first required minimum distribution be received? Your required beginning date is April 1 of the year following the year in which you reach age 70½. For example, if you reached age 70½ during 1996, you must receive a minimum distribution for 1996 no later than April 1, 1997. You will also have to receive a minimum distribution for 1997 by December 31, 1997. Thus, if you do not take your first distribution during 1996, and wait until between January 1 and April 1, 1997, you will have to make two distributions in 1997, one by April 1 and another by December 31. This could increase your 1997 taxable income substantially. Distributions for later years must be made by December 31 of each year.

If you reach age 70½ during 1997, your first distribution must be no later than April 1, 1998. If you have an individual retirement annuity, your insurance company should gear your payments to meet minimum distribution requirements.

Key decisions to make by your required beginning date. By your required beginning date (April 1 of the year after the year you reach age 70½), you should designate a beneficiary and elect either the term-certain or recalculation method of adjusting life expectancy. As discussed below, your choices will determine the minimum amount you must receive from your IRA each year, and, in some cases, also determine the payout options for your beneficiaries after your death.

For example, the age of your designated beneficiary affects the calculation of the minimum distributions you must receive, as discussed below under Step 2. If you select a charitable organization as your beneficiary, or your estate as the beneficiary, you will have to use your single life expectancy in figuring your required minimum distributions.

If you have not chosen a life expectancy method by your required beginning date, the terms of the plan may apply the recalculation method as the default method, which could be disadvantageous following your death or the death of your spouse if he or she is your designated beneficiary; *see* the discussion of life expectancy methods under Step 3 below.

Penalty Waiver for Reasonable Mistakes

The IRS may waive the penalty for insufficient withdrawals if they are due to reasonable error and if steps have been taken in order to remedy the situation. You must submit evidence to account for shortfalls in withdrawals and how you are rectifying the situation. The IRS has indicated that examples of acceptable reasons for insufficient withdrawals include erroneous advice from the sponsoring organization or other pension advisors or that your own good faith efforts to apply the required withdrawal formula produced a miscalculation or misunderstanding of the formula. You should attach your letter of explanation to Form 5329. You must pay the penalty; if the IRS grants a waiver, it will refund the penalty.

FIGURING MINIMUM IRA DISTRIBUTIONS

Your IRA trustee should help you figure how much you must withdraw to avoid an IRS penalty. To compute the annual minimum required distribution yourself, you generally divide the applicable life expectancy into the account balance at the end of the prior year. More specifically, follow these steps for *each* of your IRAs:

Step 1. Find the account balance of your IRA as of the previous December 31. If you reach age 70½ during 1996, the account balance to be used for figuring your first required minimum distribution is the account balance for December 31, 1995, even if the actual distribution for 1996 is not made until the first quarter of 1997 (January 1–April 1). For purposes of figuring your required minimum distribution for 1997, use the 1996 year-end balance, reduced by the first-year distribution if you took it in the first quarter of 1997.

Step 2. Find your life expectancy. For the year you reach age 70½, use the joint life and last survivor life expectancy of you and the beneficiary that was designated by the required beginning date (April 1 of the year after the year you reach age 70½). If you name more than one beneficiary, the age of the oldest beneficiary (the shortest life expectancy) is taken into account. Joint life and last survivor life expectancy is found in IRS unisex Table VI, a sample section of which is shown on page 172. The rest of the table is in IRS Publication 939 and can also be obtained from your IRA trustee.

Use only your single life expectancy from Table V at ¶7.23 if your beneficiary as of the required beginning date is your estate or a charitable organization; the charity or estate has no life expectancy. Your single life expectancy is also used if no beneficiary has been designated by the required beginning date.

The initial joint life and last survivor life expectancy of you and your beneficiary is determined by your ages on your respective birthdays in the year in which you reach age 70½. For example, if you were born in October 1925, you reached age 70½ in April 1996 and age 71 on your birthday in October 1996. Assume your beneficiary is age 67 on his or her birthday in 1996. For purposes of figuring your first required IRA distribution for the year 1996 (due by April 1, 1997), your joint life and last survivor expectancy from the table on page 172 is 21.7 years (using ages 71 and 67). For 1997 and later years, the required minimum distributions will depend on whether you choose to recalculate your life expectancies annually or to use the term-certain method; *see* Step 3 below.

Is your nonspouse beneficiary more than 10 years younger than you are? You are not allowed to use the actual joint life expectancy of you and a beneficiary who is more than 10 years younger than you are, unless the beneficiary is your spouse. If your beneficiary is not your spouse, you must treat the beneficiary as being only 10 years younger than yourself, although he or she may be much younger. This 10-year age rule is called the MDIB (minimum distribution incidental benefit) requirement.

For example, if you are age 71 on your birthday in the year you reach age 70½, and your beneficiary is your 20-year-old grandchild, the grandchild is considered to be age 61 for purposes of figuring your initial joint life and last survivor expectancy. In subsequent years, you are each considered to be one year older, so your joint life and last survivor expectancy for the second distribution year is based on ages 72 and 62, for the third year it is based on ages 73 and 63, and so on.

The MDIB requirement applies each year while you are alive, regardless of whether you filed an election with the IRA plan to use the term-certain method or recalculation method of adjusting life expectancy as discussed under Step 3 below. However, the MDIB requirement no longer applies in years after your death. The payout rules to your beneficiary *will* depend on whether you elected the term-certain or recalculation method; *see* Step 3 and the rules for non-spouse beneficiaries at ¶8.15.

Step 3. How to adjust life expectancy each year. The initial joint life and last survivor life expectancy for you and your beneficiary has to be adjusted every year to figure the minimum required IRA withdrawal. There are four methods for adjusting life expectancy—the *recalculation* method, the *term-certain* method, the *MDIB* method and the *hybrid* method.

You must use the MDIB rule to figure each of your annual required minimum distributions if your designated beneficiary as of the required beginning date is more than 10 years younger than you are and is not your spouse. This is true regardless of whether you have elected in the IRA plan to use the term-certain or the recalculation method; *see* Step 2 above.

If you do not have to use the MDIB rule for a nonspouse designated beneficiary, a *hybrid* method (*see* the next page) applies where you do not elect the term-certain method.

Under the terms of many IRA plans, the recalculation method applies automatically unless an election to use the term-certain method is specifically made by the required beginning date (April 1 of the year after the year you reach age 70½). Check your plan to determine whether a specific election is necessary to apply the method you want. The method that takes effect as of the required beginning date cannot be changed.

Recalculation Method. Under the *recalculation* method, your life expectancy may be recalculated annually and so may the life expectancy of a *spouse* who was designated as your beneficiary as of the required beginning date. If your beneficiary is *not* your spouse, you may recalculate your own life expectancy under the hybrid method discussed in the next column.

If your spouse is your beneficiary and you both recalculate life expectancy, this means that each year your joint life expectancy from the IRS table is based on your ages at your birthdays in that year. For example, assume that your spouse is your beneficiary and that in 1996, the year you reached age 70½, you were age 71 on your birthday and your spouse was age 67 on his or her birthday. Based on ages 71 and 67, your initial joint life and last survivor life expectancy from the IRS table (page 172) is 21.7 years, for purposes of figuring your required distribution for 1996. If you and your spouse recalculate life expectancies, your adjusted joint life expectancy for 1997, based on ages 72 and 68 (your ages on your birthdays in 1997), would be 20.8 from the IRS table. For 1998, based on ages 73 and 69, the adjusted joint life expectancy from the IRS table would be 20.0, and for 1999 it would be 19.1 (ages 74 and 70). As you can see, the joint life expectancy is reduced by *less than one* with each annual recalculation; as you grow older, the annual reduction in joint life expectancy becomes even smaller.

Term-certain method. Under the *term-certain* method, you do not have to use IRS life expectancy tables once you determine your initial joint life and last survivor expectancy for you and your beneficiary. You simply reduce that initial life expectancy by one in each later year. This method may be used with a spouse or non-spouse beneficiary unless you must use the MDIB rule for a non-spouse beneficiary as discussed in Step 2. Thus, if your initial joint life and last survivor expectancy for 1996 based on ages 71 and 67 is 21.7 years, it would be reduced to 20.7 for 1996, 19.7 for 1997, 18.7 for 1998, and so on under the term-certain method.

Should you use the recalculation or term-certain method? Each method has advantages and disadvantages. The recalculation method generally allows you to conserve principal longer than the term-certain method by requiring you to take slightly smaller annual distributions; life expectancy is reduced each year by less than one under the recalculation method, while under the term-certain method life expectancy is reduced by a full year.

However, there is a disadvantage to the recalculation method if your spouse is your beneficiary and your spouse dies first. After the death of a recalculating owner or recalculating spousal beneficiary, that person's life expectancy is reduced to zero starting in the year after the year of death. Thus, if your spouse is your designated beneficiary and he or she dies first, you must use your single life expectancy to figure your minimum required distributions starting in the year after the year of your spouse's death; the joint life expectancy rules may no longer be used. Then, when you die, your secondary beneficiary will have to receive the entire account by the end of the year following the year of your death and pay tax on the entire amount. Similar rules would apply to your surviving spouse and your secondary beneficiary if you die before your spouse and your spouse receives distributions from your account as a *beneficiary*, but the payout period can be extended where a surviving spouse elects to be treated as the *owner* of the IRA; the options for surviving spouses are detailed in ¶8.15.

If your estate is the beneficiary, these recalculation rules may be particularly costly. Since your life expectancy is reduced to zero as of the year following the year of your death, and the estate has no life expectancy on which distributions may be based, the entire account must be distributed to the estate by the end of the year after the year of your death.

On the other hand, when you elect the term-certain method to figure your minimum required distributions, the balance of the initial joint life expectancy period remains available following the death of you or your beneficiary. This allows the survivor to spread out the distributions, and the tax on the distributions, over the rest of the term-certain period.

Hybrid method may be required if your beneficiary is not your spouse. If you do not elect the term-certain method, you must use a *hybrid* method of determining your joint life and last survivor expectancy if your nonspouse designated beneficiary is not more than 10 years younger than you are (so the MDIB rule is inapplicable). Under the hybrid method, you use your age as of your birthday in each year and must adjust the beneficiary's age following the steps in Example 3 at the end of this section.

Step 4. Divide the account balance from Step 1 by the life expectancy from Step 2. This is the minimum amount you must receive. If you have more than one IRA, divide Step 1 by Step 2 for each account and *see* Step 5.

Step 5. If you have more than one IRA, total the Step 4 amounts for all the accounts. This is the *minimum* you must receive for the year; you are of course free to withdraw more than that. Although you must calculate the minimum required distribution separately for each account, you do not have to make withdrawals from each of them. The total minimum required distribution from all accounts may be taken from any one account, or more than one account if you prefer. For example, if you have five bank IRAs you may take the entire required distribution from the bank where you have the largest balance, or from any other combination of banks. *See* Example 2 below. The entire distribution is taxable unless part is allocable to nondeductible IRA contributions, as explained in ¶8.8.

Note: For further information on calculating minimum required distributions, *see* IRS proposed regulations Sections 1.408-8 and 1.401(a)(9)-1. Also *see* the instructions to Form 5329.

EXAMPLES

1. Joe Blake reached age 70½ in March 1996. A minimum distribution for 1996 must be received by April 1, 1997. As of December 31, 1995, Joe's IRA balance was $26,300. The 1995 year-end balance is used in the computation even if the distribution for 1996 is made in the first quarter of 1997 (by the April 1 deadline). Joe's beneficiary is his wife, who is age 63 on her birthday in 1996. On his 1996 birthday, Joe is age 71.

   Step 1. Account balance of $26,300.
   Step 2. Joint life and last survivor expectancy from the table on page 172 is 24 years, using ages 71 and 63.
   Step 3. Divide Step 1 by Step 2.

   $26,300 ÷ 24 = $1,096. Joe must receive the $1,096 by April 1, 1997.

The second minimum distribution, due by December 31, 1997, is based upon the 1996 year-end account balance, but if the 1996 distribution was not made until early 1997 (by April 1), the account balance is reduced by that distribution. Thus, assume that Joe took the $1,096 distribution for 1996 in March 1997 and that the 1996 year-end balance is $27,500. For purposes of figuring the required distribution for 1997, an account balance of $26,404 ($27,500 – $1,096) is used.

Assuming Joe and his wife recalculate their life expectancies, their joint expectancy would be 23.1 (using ages 72 and 64). Thus, the minimum required distribution for 1997, due by December 31, 1997, would be $1,143 ($26,404 ÷ 23.1).

However, if Joe had elected not to recalculate life expectancy but to use the term-certain method, the first-year joint life expectancy of 24 years would be reduced to 23 years. The minimum 1997 distribution would be $1,148 ($26,404 ÷ 23).

2. Cynthia Lowell has two IRAs. She became age 70½ on January 15, 1996, and thus must receive her first distribution by April 1, 1997. The beneficiary of IRA-1 is her brother, who is age 61 on his birthday in 1996; the account balance of IRA-1 as of December 31, 1995, was $100,000. The beneficiary of IRA-2 is her husband, who was age 74 on his 1996 birthday; the account balance at the end of 1995 was $10,000.

   IRA-1: The first minimum required distribution is $3,952.57. This is the account balance of $100,000 divided by 25.3, the joint life and last survivor expectancy using ages 71 and 61 from the table.

   IRA-2: The first minimum required distribution is $537.63, the account balance of $10,000 divided by 18.6, the joint life and last survivor expectancy using ages 71 and 74.

   The total required distribution of $4,490.20 from both IRAs must be received by April 1, 1997. Cynthia may withdraw the money from either one or both of the IRAs.

   If the withdrawal is delayed until the first quarter of 1997, the 1996 year-end balance is reduced by the withdrawal when she figures her minimum required distribution for 1997. The distribution for 1997 must be received by December 31, 1997.

3. Assume that in Example 1, Joe Blake's beneficiary was not his wife but his brother Frank, who was 63 on his birthday in 1996. Also assume that Joe did not elect to use the term-certain method. For 1996, the first distribution year, the required distribution is $1,096 (the same as under Step 3 of Example 1). To figure the required minimum distribution for 1997, the second distribution year, Joe's recalculated age is 72 (his age on his birthday in 1997). To determine Frank's revised age, and then their joint life and last survivor life expectancy, the following hybrid method computation is made:

Step 1.	Frank's life expectancy in first distribution year of 1996, using age 63. Life expectancy is shown in Table V at ¶7.23.	21.6
Step 2.	Number of years that have passed since the first distribution year of 1996 (nearest whole number).	1.0
Step 3.	Remaining life expectancy (Step 1 *minus* Step 2)	20.6
Step 4.	Find the age corresponding to the life expectancy in Table V (¶7.23), that is closest to, but less than, the Step 3 life expectancy of 20.6. In Table V, 20.6 falls between an expectancy of 20.8 years for age 64 and 20.0 years for age 65; thus, the higher age of 65 is used.	65
Step 5.	Joe's revised age for 1997.	72
Step 6.	Joint life and last survivor expectancy using ages 72 and 65 (Steps 4 and 5) from table.	22.5

For 1997, Joe's minimum required distribution using the revised joint life expectancy of 22.5 years is $1,174 ($26,404 account balance ÷ 22.5).

For 1998, Joe's age in Step 5 will be 73, and the computation for Frank will be similar, except that Step 3 remaining life expectancy will be 19.6.

¶8.15 Inherited IRAs

When an IRA owner dies, the rules for handling the account depend on who the beneficiary is. A surviving spouse beneficiary has certain advantages not available to other beneficiaries.

SURVIVING SPOUSE

Treating an IRA as your own. If you are the beneficiary of your deceased spouse's IRA, you may elect to treat it as your *own* IRA by rolling it over to an IRA in your name, by making IRA contributions to the account, or by making rollover contributions into the account from other IRAs or from a qualifying employer-plan distribution; *see* ¶8.10.

An advantage of treating the amount *as your own* is that if you are under age 70½, you may delay the start of your distributions until your required beginning date (April 1 of the year after the year in which you reach 70½), at which time your minimum required distributions may be based on the joint life and last survivor life expectancy of yourself and the beneficiary you have designated; *see* ¶8.14. Even if you are over age 70½ when your spouse dies, treating the IRA as your own and naming your own beneficiary generally allows you to take smaller distributions from the account than if you did not treat the IRA as your own but instead took distributions from the account as a beneficiary; *see* below. Distributions from the account are taxable and, if received before age 59½, may be subject to the 10% penalty for early withdrawals; *see* ¶8.12.

Receiving distributions as a beneficiary. If you do not want to treat the account as your own IRA, you may receive payments from the account as a beneficiary; the account stays in the name of your deceased spouse. As a beneficiary, distributions you receive before you are age 59½ are *not* subject to the 10% penalty for early withdrawals (¶8.12). The payout period for withdrawing funds from the account as a *beneficiary* depends on when your spouse died:

- If your spouse died *after* the required beginning date for distributions, which is April 1 of the year after the year in which he or she reached age 70½ (¶8.14), and you do not elect to treat the IRA as your own, you generally must receive distributions from the IRA at least as rapidly as your spouse was receiving them.

  If your spouse had elected the *term-certain* method (¶8.14) for figuring distributions, you must receive minimum distributions over the balance of the term-certain period. That is, for each year, you divide the account balance at the end of the prior year (*see* Step 1 at ¶8.14) by the joint life and last survivor expectancy for both of you in the year your spouse reached age 70½ *minus* one year for each year that has passed. For example, if in the year your spouse reached age 70½ your joint life and last survivor life expectancy (Step 2 at ¶8.14) was 21.7 years and your spouse died after receiving three annual required minimum distributions under the term-certain method, you use the balance of the term-certain period, or 18.7 years, to figure your first required minimum distribution.

  However, if your spouse was *recalculating* life expectancy annually (¶8.14), his or her life expectancy is treated as zero starting in the year following the year of death. For the years after the year of death, your minimum distributions are based on your single life expectancy, which is either your recalculated expectancy, or, if you were not recalculating, your life expectancy in the first distribution year (shown in Table V at ¶7.23), reduced by one for each elapsed year.
- If your spouse died *before* the required beginning date, the IRA plan will probably allow you to either (1) withdraw funds from the IRA over your life expectancy, or (2) withdraw the entire account balance by the end of the fifth year following the year of your spouse's death. Some plans allow the account owner to elect the method to be used by his or her beneficiary, and some plans do not allow a choice but specify the method.

  If the life expectancy method is elected or specified for you, you do not have to begin the distributions until the later of (1) December 31 of the year in which your spouse would have reached age 70½, or (2) December 31 of the year following the year of your spouse's death.

BENEFICIARIES OTHER THAN SURVIVING SPOUSES

If you inherit an IRA from someone who was not your spouse, you may not treat it as your own IRA account. Thus, you may not make contributions to the account or roll it over to another IRA. You must begin receiving withdrawals from the plan. Distributions you receive as a beneficiary before age 59½ are *not* subject to the 10% early withdrawal penalty (¶8.12). The payout period for withdrawing funds from the account as a beneficiary depends on when the account owner died:

- If the owner died *after* the required beginning date for distributions (April 1 of the year after the year in which the owner reached 70½), you generally must receive distributions at least as rapidly as the owner was receiving them. If the owner was using the *term-certain method* (¶8.14), you must receive minimum distributions over the balance of the term-certain period.

  A similar rule applies if the owner had filed a term-certain election with the IRA plan but was nevertheless required to use the MDIB method because you were more than 10 years younger than the owner (*see* Step 2 at ¶8.14). The life expectancy you use to figure your minimum required distributions is the balance of the initial term-certain period–your joint life and last survivor expectancy for the year in which the owner reached age 70½, minus one year for each year that has passed.

  However, if the owner used the hybrid method (*see* Step 3 at ¶8.14), your minimum distributions starting in the year after the year of death are based on your single life expectancy as of the first distribution year (Table V at ¶7.23), reduced by one for each elapsed year.
- If the owner died *before* the required beginning date, the inherited plan may give you the option of receiving funds from the account over your life expectancy or over the five-year period following the owner's death. Some plans specify which method must be used or permit the owner to designate the method.

  If the IRA plan gives you the choice of taking withdrawals from the account over your life expectancy, you may choose this option by beginning distributions no later than December 31 of the year following the year of the IRA owner's death. If the plan does not allow the life expectancy option, or if you choose the five-year method, you must withdraw the entire account by December 31 of the fifth year following the year of the owner's death.

Simplified Employee Pension Plans (SEPs)

¶8.16 SEP Basics

A simplified employee pension plan (SEP) set up by an employer allows the employer to contribute to an employee's IRA account more money than allowable under regular IRA rules. For 1996, your employer may contribute and deduct up to 15% of your compensation or $30,000, whichever is less. Your employer's SEP contributions are excluded from your pay and are not included on Form W-2 unless they exceed the limit. If contributions exceed the limit, a 6%

penalty tax may be imposed unless the excess (plus allowable income) is withdrawn by the due date of the return, plus extensions; *see* ¶8.7.

Self-employed plans. Self-employed individuals may set up a SEP as an alternative to a Keogh plan; *see* Chapter 41.

CAUTION

Employees over Age 70½

An employee over age 70½ may still participate in an employer SEP plan but may not make personal IRA contributions. Minimum distributions from the plan must begin as discussed in ¶7.13.

Eligibility. A SEP must cover all employees who are at least age 21, earn over $400 in 1996 (this amount is adjusted annually for inflation), and who have worked for the employer at any time during at least three of the past five years. Union employees covered by union agreements may generally be excluded.

SEP salary reduction arrangements. Qualifying small employers may set up salary reduction SEPs which allow employees to contribute a portion of their pay to the plan instead of receiving it in cash; *see* ¶8.17.

SEP distributions. Distributions from a SEP are subject to the regular IRA distribution rules at ¶8.8.

¶8.17 Salary Reduction SEP and SIMPLE Accounts

Qualifying small employers may offer employees the option of deferring a portion of their salary to an IRA. There are two types of salary reduction IRAs, with different eligibility and contribution rules:

1. Salary reduction SEPs established before 1997, and
2. "SIMPLE" accounts established after 1996 under a new law.

After 1996, an employer may establish a SIMPLE plan but not a salary reduction SEP. A salary reduction SEP that was established before 1997 may continue to receive contributions under the prior law rules, and employees hired after 1996 may participate in the plan, subject to those rules.

Salary reduction SEPs established before 1997. Salary reductions are allowed for a year only if the employer had no more than 25 employees eligible to participate in the SEP at any time during the prior taxable year. Furthermore, at least 50% of the eligible employees must elect the salary reduction option, and the deferral percentage for highly compensated employees may not exceed 125% of the average contribution of regular employees. State or local government agencies and tax-exempt organizations may not set up salary reduction SEPs.

If salary reductions are allowed, the maximum salary reduction contribution for 1996 is $9,500; the limit is subject to future inflation adjustments. Deferrals over $9,500 are taxable, and if not timely distributed to the employee, can be taxed again when distributed from the plan.

If an employee contributes to both a SEP and a 401(k) plan, the annual limit ($9,500 for 1996) applies to the total salary reductions from both plans. If an employee makes salary reduction contributions to a SEP and also to a tax-sheltered annuity plan (¶7.20), the annual limit generally applies to the total salary reductions to both plans. In some cases, employees with at least 15 years of service may be able to defer an additional $3,000 to the tax-sheltered annuity plan as discussed at ¶7.20.

Salary reduction deferrals are treated as employer contributions. For 1996, total employer contributions including salary reductions may not exceed the lesser of 15% of pay or $22,500. $22,500 is 15% of $150,000, the maximum amount of compensation that the plan may take into account for 1996; this amount may be increased for 1997 by an inflation adjustment. For certain collectively bargained plans, the compensation limit for 1996 is $250,000.

SIMPLE plans established after 1996. Starting in 1997, a SIMPLE plan may be set up by an employer that has no other retirement plan and who during the preceding year had 100 or fewer employees earning at least $5,000. Employees may elect to defer a specified percentage of their pay to the plan, but no more than $6,000 per year; after 1997 the $6,000 limit may be adjusted for inflation. Employees with at least $5,000 of pay in any two preceding years are eligible to participate, so long as their expected pay for the current year is also $5,000 or more.

The employer generally must match the first 3% of an employee's salary reduction deferral, but for two out of every five years, the employer may elect a contribution percentage of as low as 1% for all eligible employees, provided notice is given to the employees before they have to make their annual deferral election. Employers also have another option. In lieu of matching, they may contribute a flat 2% of each eligible employee's compensation.

An employee's distributions from a SIMPLE account are generally subject to the same rules as IRAs (*see* ¶8.8). However, within the first two years of plan participation, the penalty for distributions before age 59½ (¶8.12) is increased from 10% to 25%.

Joint Life and Last Survivor Life Expectancy (See ¶8.12)

AGES	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59
40	46.9	46.5	46.2	45.9	45.6	45.3	45.1	44.8	44.6	44.4	44.2	44.1	43.9	43.8	43.7
41	46.3	45.9	45.5	45.2	44.9	44.6	44.3	44.1	43.9	43.6	43.4	43.3	43.1	43.0	42.8
42	45.7	45.3	44.9	44.5	44.2	43.9	43.6	43.3	43.1	42.9	42.7	42.5	42.3	42.1	42.0
43	45.1	44.7	44.3	43.9	43.6	43.2	42.9	42.6	42.4	42.1	41.9	41.7	41.5	41.3	41.2
44	44.6	44.1	43.7	43.3	42.9	42.6	42.2	41.9	41.7	41.4	41.2	40.9	40.7	40.5	40.4
45	44.1	43.6	43.2	42.7	42.3	42.0	41.6	41.3	41.0	40.7	40.4	40.2	40.0	39.7	39.6
46	43.6	43.1	42.6	42.2	41.8	41.4	41.0	40.6	40.3	40.0	39.7	39.5	39.2	39.0	38.8
47	43.2	42.6	42.1	41.7	41.2	40.8	40.4	40.0	39.7	39.3	39.0	38.7	38.5	38.2	38.0
48	42.7	42.2	41.7	41.2	40.7	40.2	39.8	39.4	39.0	38.7	38.4	38.1	37.8	37.5	37.3
49	42.3	41.8	41.2	40.7	40.2	39.7	39.3	38.8	38.4	38.1	37.7	37.4	37.1	36.8	36.6
50	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.3	37.9	37.5	37.1	36.8	36.4	36.1	35.9
51	41.6	41.0	40.4	39.8	39.3	38.7	38.2	37.8	37.3	36.9	36.5	36.1	35.8	35.5	35.2
52	41.3	40.6	40.0	39.4	38.8	38.3	37.8	37.3	36.8	36.4	35.9	35.6	35.2	34.8	34.5
53	41.0	40.3	39.7	39.0	38.4	37.9	37.3	36.8	36.3	35.8	35.4	35.0	34.6	34.2	33.9
54	40.7	40.0	39.3	38.7	38.1	37.5	36.9	36.4	35.8	35.3	34.9	34.4	34.0	33.6	33.3
55	40.4	39.7	39.0	38.4	37.7	37.1	36.5	35.9	35.4	34.9	34.4	33.9	33.5	33.1	32.7
56	40.2	39.5	38.7	38.1	37.4	36.8	36.1	35.6	35.0	34.4	33.9	33.4	33.0	32.5	32.1
57	40.0	39.2	38.5	37.8	37.1	36.4	35.8	35.2	34.6	34.0	33.5	33.0	32.5	32.0	31.6
58	39.7	39.0	38.2	37.5	36.8	36.1	35.5	34.8	34.2	33.6	33.1	32.5	32.0	31.5	31.1
59	39.6	38.8	38.0	37.3	36.6	35.9	35.2	34.5	33.9	33.3	32.7	32.1	31.6	31.1	30.6

Joint Life and Last Survivor Life Expectancy (See ¶8.14)

Ages	60	61	62	63	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80
70	26.2	25.6	24.9	24.3	23.7	23.1	22.5	22.0	21.5	21.1	20.6	20.2	19.8	19.4	19.1	18.8	18.5	18.3	18.0	17.8	17.6
71	26.0	25.3	24.7	24.0	23.4	22.8	22.2	21.7	21.2	20.7	20.2	19.8	19.4	19.0	18.6	18.3	18.0	17.7	17.5	17.2	17.0
72	25.8	25.1	24.4	23.8	23.1	22.5	21.9	21.3	20.8	20.3	19.8	19.4	18.9	18.5	18.2	17.8	17.5	17.2	16.9	16.7	16.4
73	25.6	24.9	24.2	23.5	22.9	22.2	21.6	21.0	20.5	20.0	19.4	19.0	18.5	18.1	17.7	17.3	17.0	16.7	16.4	16.1	15.9
74	25.5	24.7	24.0	23.3	22.7	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.2	17.7	17.3	16.9	16.5	16.2	15.9	15.6	15.4
75	25.3	24.6	23.8	23.1	22.4	21.8	21.1	20.5	19.9	19.3	18.8	18.3	17.8	17.3	16.9	16.5	16.1	15.8	15.4	15.1	14.9
76	25.2	24.4	23.7	23.0	22.3	21.6	20.9	20.3	19.7	19.1	18.5	18.0	17.5	17.0	16.5	16.1	15.7	15.4	15.0	14.7	14.4
77	25.1	24.3	23.6	22.8	22.1	21.4	20.7	20.1	19.4	18.8	18.3	17.7	17.2	16.7	16.2	15.8	15.4	15.0	14.6	14.3	14.0
78	25.0	24.2	23.4	22.7	21.9	21.2	20.5	19.9	19.2	18.6	18.0	17.5	16.9	16.4	15.9	15.4	15.0	14.6	14.2	13.9	13.5
79	24.9	24.1	23.3	22.6	21.8	21.1	20.4	19.7	19.0	18.4	17.8	17.2	16.7	16.1	15.6	15.1	14.7	14.3	13.9	13.5	13.2
80	24.8	24.0	23.2	22.4	21.7	21.0	20.2	19.5	18.9	18.2	17.6	17.0	16.4	15.9	15.4	14.9	14.4	14.0	13.5	13.2	12.8
81	24.7	23.9	23.1	22.3	21.6	20.8	20.1	19.4	18.7	18.1	17.4	16.8	16.2	15.7	15.1	14.6	14.1	13.7	13.2	12.8	12.5
82	24.6	23.8	23.0	22.3	21.5	20.7	20.0	19.3	18.6	17.9	17.3	16.6	16.0	15.5	14.9	14.4	13.9	13.4	13.0	12.5	12.2
83	24.6	23.8	23.0	22.2	21.4	20.6	19.9	19.2	18.5	17.8	17.1	16.5	15.9	15.3	14.7	14.2	13.7	13.2	12.7	12.3	11.9
84	24.5	23.7	22.9	22.1	21.3	20.5	19.8	19.1	18.4	17.7	17.0	16.3	15.7	15.1	14.5	14.0	13.5	13.0	12.5	12.0	11.6
85	24.5	23.7	22.8	22.0	21.3	20.5	19.7	19.0	18.3	17.6	16.9	16.2	15.6	15.0	14.4	13.8	13.3	12.8	12.3	11.8	11.4